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FEATURE COMMENT: Vicarious Corporate Liability For Double Damages Under The AKA—Fifth Circuit Opens The Door To Punishing The Employer When Its Employees Self-Deal

U.S. ex rel. Vavra, et al. v. Kellogg Brown & Root, Inc., 2013 WL 3779225 (5th Cir. July 19, 2013)

In a case of first impression with potentially far-reaching consequences, the U.S. Court of Appeals for the Fifth Circuit has ruled that a contractor may be held vicariously liable for double damages under the Anti-Kickback Act (AKA) when the kickback is taken by an employee, not the contractor. Thus, having first been victimized by a dishonest and disloyal employee, a contractor may then also suffer enhanced civil penalties in a lawsuit by a qui tam relator or the Department of Justice.

The decision significantly raises the stakes for contractors who fail to monitor their employees or who, despite their best efforts, fall victim to employee self-dealing. This case and others, including the recent sentencing of former Army Corps of Engineers program manager Kerry Khan for leading a massive $30 million kickback scheme, illustrate that contractors' potential exposure is great.

The AKA—The AKA prohibits contractors from providing, soliciting or accepting kickbacks in connection with Federal Government prime and subcontracts. 41 USCA § 8702. A "kickback" includes "any ... thing of value, or compensation of any kind that is provided to a prime contractor, prime contractor employee, subcontractor, or subcontractor employee to improperly obtain or reward favorable treatment in connection with a prime contract or a subcontract relating to a prime contract." 41 USCA § 8701(2).

Broadly speaking, there are two types of kickbacks. The first occurs when a prime contractor or subcontractor takes a kickback from a lower-tier subcontractor in exchange for favorable treatment. This type of kickback typically benefits the higher-tier company by increasing its net revenue. The second type of kickback occurs when an employee engages in self-dealing by receiving a kickback for his personal benefit. This type of kickback does not benefit the employer. Indeed, it creates a conflict of interest that harms the employer by inducing the employee to award or administer subcontracts in a manner that does not achieve the best terms, pricing and performance for the employer.

This, along with the liability risk, is a major reason that virtually all company business conduct policies prohibit employees from accepting significant gifts from suppliers, or at least require disclosure and approval. Both types of kickbacks may result in inflated subcontract prices, which may ultimately be borne by the prime contractor, the customer or a combination of the two.

Section 8706(a) of the AKA establishes two civil monetary penalties for kickbacks.

> (a) Amount—The Federal Government in a civil action may recover from a person—
> (1) that knowingly engages in conduct prohibited by section 8702 of this title a civil penalty equal to—
> (A) twice the amount of each kickback involved in the violation; and
> (B) not more than $[11,000] for each occurrence of the prohibited conduct; and
> (2) whose employee, subcontractor, or subcontractor employee violates section 8702 of this title by providing, accepting, or charging a kickback a civil penalty equal to the amount of that kickback.

41 USCA § 8706(a).

Although subsection (a)(1) permits the Government to recover twice the amount of each kickback and $11,000 per occurrence for "knowing" violations of the AKA, subsection (a)(2) provides for a penalty equal to the amount of the kickback on a strict liability basis. It is clear that an employer is strictly liable under (a)(2) if an employee engages in self-dealing, even without the employer's knowledge. It is also clear that a company may be liable under (a)(1) if the company receives a kickback. The issue in *U.S. ex rel. Vavra v. KBR*—whose answer is *not* so obvious—was whether and under what circumstances an employer may be held vicariously liable for the greater penalty imposed by subsection (a)(1) when an employee, not the company itself, takes a kickback.

The Kickbacks in *U.S. ex rel. Vavra v. KBR*— The Vavra case began in 2004 when two plaintiff relators filed a qui tam action under the federal civil False Claims Act alleging that from January 2002 to April 2005, Kellogg Brown & Root, Inc. (KBR) engaged in a kickback scheme in exchange for awarding subcontracts for the transport of U.S. military equipment and supplies to Iraq, Afghanistan and Kuwait. *U.S. ex rel. Vavra v. Kellogg Brown & Root, Inc.*, 903 F. Supp. 2d 473 (E.D. Tex. 2011).

KBR had awarded the subcontracts at issue under the Logistics Civil Augmentation Program III (LOGCAP III) prime contract that the Army awarded to KBR in 2001. The relators alleged that KBR's corporate traffic supervisor for LOGCAP III and four other KBR employees accepted kickbacks from two of KBR's subcontractors. The alleged kickbacks included meals, tickets to various sports events, golf outings, and other gifts and entertainment. By the time the civil case reached the Fifth Circuit, KBR's corporate traffic supervisor and one of the subcontractor's employees had already pleaded guilty to criminal charges arising from the kickbacks.

In May 2010, the Government intervened in the case and filed its own complaint against KBR, alleging, among other counts, that the company had "knowingly" violated the AKA and was liable for double damages under subsection (a)(1). KBR moved to dismiss on the basis that it could not be held liable under subsection (a)(1) for its employees' misconduct. KBR maintained that vicarious corporate liability can only arise under subsection (a)(2), which the Government did not invoke in its complaint. The Government responded to KBR's motion by arguing that KBR could be held vicariously liable under subsection (a)(1) because the knowledge of KBR's employees who were involved in the kickback scheme could be imputed to KBR.

The District Court Decision—The district court agreed with KBR's arguments and dismissed the AKA count. In construing the statute, the district court noted that only subsection (a)(2), not subsection (a)(1), references kickbacks involving an "employee, subcontractor, or subcontractor employee" of a company. The district court reasoned that to read (a)(1) to permit vicarious liability based on employee self-dealing would render the (a)(2) language superfluous. Thus, the district court concluded that the employer cannot be liable for double damages and per-occurrence penalties.

The district court also found that dismissal was required for the additional reason that the Government had not alleged that KBR's employees who were involved in the kickback scheme acted with intent to benefit their employer. The district court relied on an FCA case, *U.S. v. Ridglea State Bank*, 357 F.2d 495 (5th Cir. 1966), in which the Fifth Circuit held that the knowledge of an employee who engages in misconduct would not be imputed to his or her employer unless the employee acted with a purpose to benefit the employer.

In *Ridglea*, the Government sued two banks under the FCA based on the activities of a self-dealing loan officer who had approved false and fraudulent loan applications while working at the banks. After the borrowers defaulted, the banks applied to the Federal Housing Authority (FHA) for reimbursement of their losses. The Fifth Circuit declined to impute the knowledge of the self-dealing loan officer to the banks, and held that the banks were not liable under the FCA for submitting their claims for reimbursement to the FHA.

The Fifth Circuit's Analysis—On appeal, the Fifth Circuit held that subsection (a)(1) does not preclude vicarious employer liability for employee misconduct involving personal kickbacks. The Fifth Circuit focused on the fact that both subsections (a)(1) and (a)(2) permit recovery from a "person," which the AKA defines as a "corporation, partnership, business association of any kind, trust, joint-stock company, or individual." 41 USCA § 8701(3). Because "person" includes artificial as well as natural persons, the Fifth Circuit concluded that subsection (a)(1) must be interpreted to permit vicarious liability.

The Fifth Circuit also disagreed with the district court's reasoning that vicarious liability under subsection (a)(1) would render the more limited penalty of (a)(2) superfluous. The Fifth Circuit noted that subsection (a)(1) provides for increased penalties against a company only where it commits a "knowing" violation, whereas the Government is able to recover only the amount of the kickback from the employer under subsection (a)(2) in the absence of corporate knowledge. Each remedy thus has a distinct scope of application.

KBR also failed to persuade the Fifth Circuit that the Government's complaint did not state a legally sufficient claim. KBR argued that the Government's complaint did not meet the pleading standard that the Fifth Circuit applied in the *Ridglea* case because it failed to allege that KBR's employees acted with intent to benefit KBR.

KBR further argued that heightened pleading standards which apply in vicarious liability actions under punitive damages statutes also should apply in the case of double damages under (a)(1), and that the Government's complaint did not meet the heightened standards. KBR thus contended that the Government failed to state a claim under the AKA because it failed to allege facts showing that its employees acted within the scope of their employment and were of managerial rank.

Unpersuaded, the Fifth Circuit distinguished its holding in *Ridglea* by finding that the mandatory $2,000 FCA penalty in that case was "meaningfully distinct" from the nonmandatory $11,000 per-occurrence penalty under the AKA. Instead, the Court invoked general principles of vicarious liability, which hold an employer responsible for employees' acts (1) that are committed either within the scope of employment and for the employer's benefit, or (2) rely on the employee's apparent authority to bind or act on behalf of the employer. Although the first branch is inapplicable to KBR, since the Government did not allege that the employees accepted kickbacks "within the scope of their employment," liability could be imposed under the second branch because of the employee's apparent authority to award and administer contracts.

The Fifth Circuit also found support in a post-*Ridglea* U.S. Supreme Court decision, *Am. Soc'y of Mech. Eng'rs, Inc. v. Hydrolevel Corp.*, 456 U.S. 556 (1982), which addressed vicarious liability under the Sherman Antitrust Act. Finally, the Fifth Circuit found that the AKA penalties have a compensatory rather than punitive purpose, and thus are not subject to heightened pleading requirements relating to scope of employment or managerial rank. For all of these reasons, the Fifth Circuit held that the Government has only to allege facts indicating that a contractor's employees acted with apparent authority in order for the contractor to be subject to the enhanced penalties of subsection (a)(1).

The Concurrence—Judge Jolly agreed with the judgment, but filed a concurring opinion taking the majority to task for its statutory analysis. In his view, the Court erred in relying heavily on the meaning of "person" in isolation, rather than as a component of the phrase "person that knowingly engages in conduct prohibited by section 8702." While the employer is unquestionably a "person," in a case of employee self-dealing, that person has not necessarily knowingly engaged in prohibited conduct.

Judge Jolly quite correctly pointed out that the apparent authority standard does not limit a company's exposure under (a)(1), since no one would offer a kickback to a person who lacks apparent authority to cause favorable treatment in regard to a subcontract. If the apparent authority rule were the "entirety of the test" for liability under subsection (a)(1), then subsection (a)(1) would impose liability identical to subsection (a)(2).

The concurrence went on to highlight the corporate knowledge element as the key to determining whether a company will be held vicariously liable under (a)(1). "The requirement that an employee not only have apparent authority, but also have sufficient responsibility or authority within the company to attribute his knowledge to the corporation itself is therefore the distinguishing aspect of [subsection (a)(1)]."

Although the concurrence focused on the knowledge aspect of subsection (a)(1), the phrase "engages in [prohibited] conduct" arguably has independent significance and could play a role in statutory construction in other circuits. Section 8702 prohibits solicitation, receipt, offering and giving of kickbacks, not knowledge of kickbacks.

In a pure case of employee self-dealing that is not designed to benefit the employer, arguably only the employee and not the employer violates § 8702, even if the employer is deemed to have some degree of knowledge of what occurred. This interpretation is also consistent with the wording of (a)(2), since that provision does *not* require that the *company* violate § 8702 in order to be liable for the amount of the kickback. On the other hand, if higher-level managers see evidence of kickbacks and have the ability to put a stop to them, but fail to do so, a court might deem that omission tantamount to the company's own "engagement" in the prohibited activity.

Unanswered Question—As both opinions acknowledged, the impact on KBR—and contractors generally—will depend greatly on how the district court applies the knowledge standard. Typically, self-dealers try to conceal the kickbacks from their immediate supervisors and higher management. If a low-level self-dealing employee's own knowledge is deemed to be company knowledge, then corporate exposure for twice the amount of the kickback is almost unlimited. On the other hand, if knowledge is attributed to the company only if the self-dealing occurs at a higher management level, or is known to officials at a higher level, then the exposure is far less.

Even if the knowledge standard is interpreted to place a meaningful limit on exposure, that element poses another type of challenge to a defendant company. Because the questions of knowledge and attribution of knowledge are highly fact-intensive, they are likely to survive dispositive pretrial motions. This increases litigation expense and litigation risk for the defendant corporation, and thereby may tend to increase the likelihood and amount of settlements—a phenomenon that will not be lost on the Justice Department or relators' counsel.

The Fifth Circuit's decision is a case of first impression. There is ample room in the statutory language for other courts to reach differing conclusions, as the district court did in this case. Moreover, even in courts that interpret the statute as the Fifth Circuit has, there is considerable room for varying and potentially inconsistent applications of the knowledge standard. If a circuit split arises, it is a near certainty that the scope of vicarious corporate liability under the AKA will eventually be reviewed by the Supreme Court. In the meantime, public contractors would be well-advised to review their internal policies and controls for prohibiting, deterring and detecting employee self-dealing.

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